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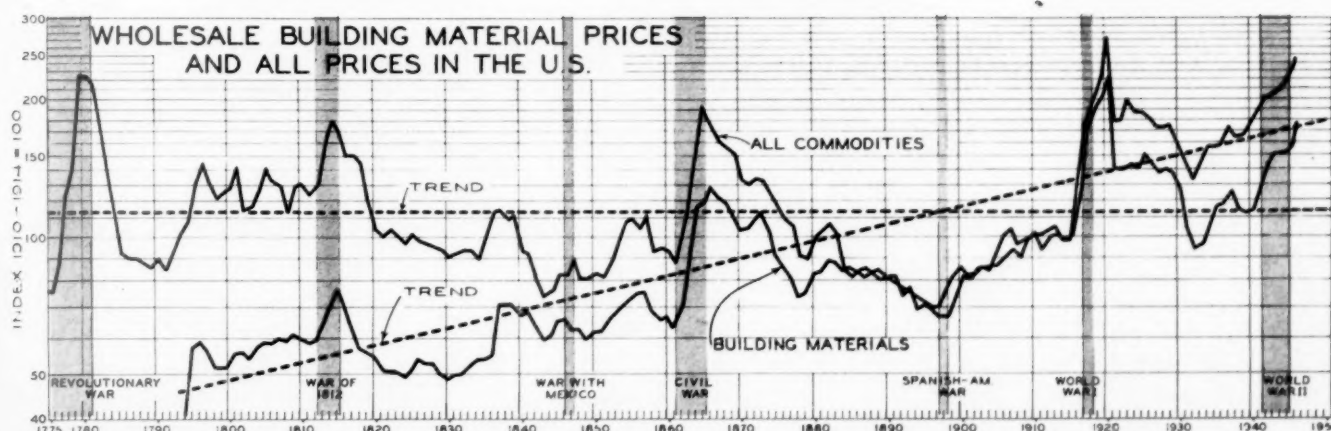
Number 15

HAZARDS TO SAFE LOANS

THE chart on page 115 shows the fluctuations in the value of the standard six-room frame house (land and improvements) by years, estimated from 1913 to 1956. The period from 1913 to January 1947 includes the construction cost of the house figured in detail by months and published regularly in bulletins by Roy Wenzlick & Co. The value of the land is estimated by years, varying according to economic conditions from \$1,200 to \$1,650. The period from January 1947 to January 1956 represents the changes in construction cost as forecast by this company on many occasions. The exact changes from 1947 to 1956 as shown on the chart are not presumed to have any degree of accuracy, but the low in 1956 was reached only after considerable research and study of all economic factors affecting costs.

The period from 1913 to 1947, or 34 years, representing slightly less than two complete cycles, provides reliable figures during one of the most critical periods in the history of America and includes two World Wars. The forecast from 1947 to 1956 covers the reconversion period of World War II and completes a 43-year period of unbalanced economic conditions in this turbulent period of our history.

It will be noticed that during this 43-year period there is a definite upward trend in construction costs. The trend line shown on the chart has been located more or less by eye, so that the areas above and below the trend line are equal. However, the angle of upward trend thus determined checks very closely with the upward trend of building material prices from 1800 to 1945, shown on the small chart at the bottom of the page. It will be noticed that the costs of World War II



average about 50 per cent above those of World War I. The high in 1947 is about 50 per cent above the high in 1924, and the expected low in 1955 would be about 50 per cent above the low in 1932. It is interesting to note that the expected low cost in 1955 is about at the level of the peak costs reached in 1920 and 1924 - also the level reached in 1942.

The appraiser should be fully informed of past changes in construction costs, as well as the changes in costs in the future which can be reasonably expected. The changes in costs from January 1947 to January 1956 are vital data to the appraiser. If he is in disagreement with the changes shown on the chart, he should make his own forecasts and base his expectations accordingly. It is also essential that the mortgagee reach a definite conclusion in his own mind as to the behavior of future construction costs so that definite mortgage patterns can be formed.

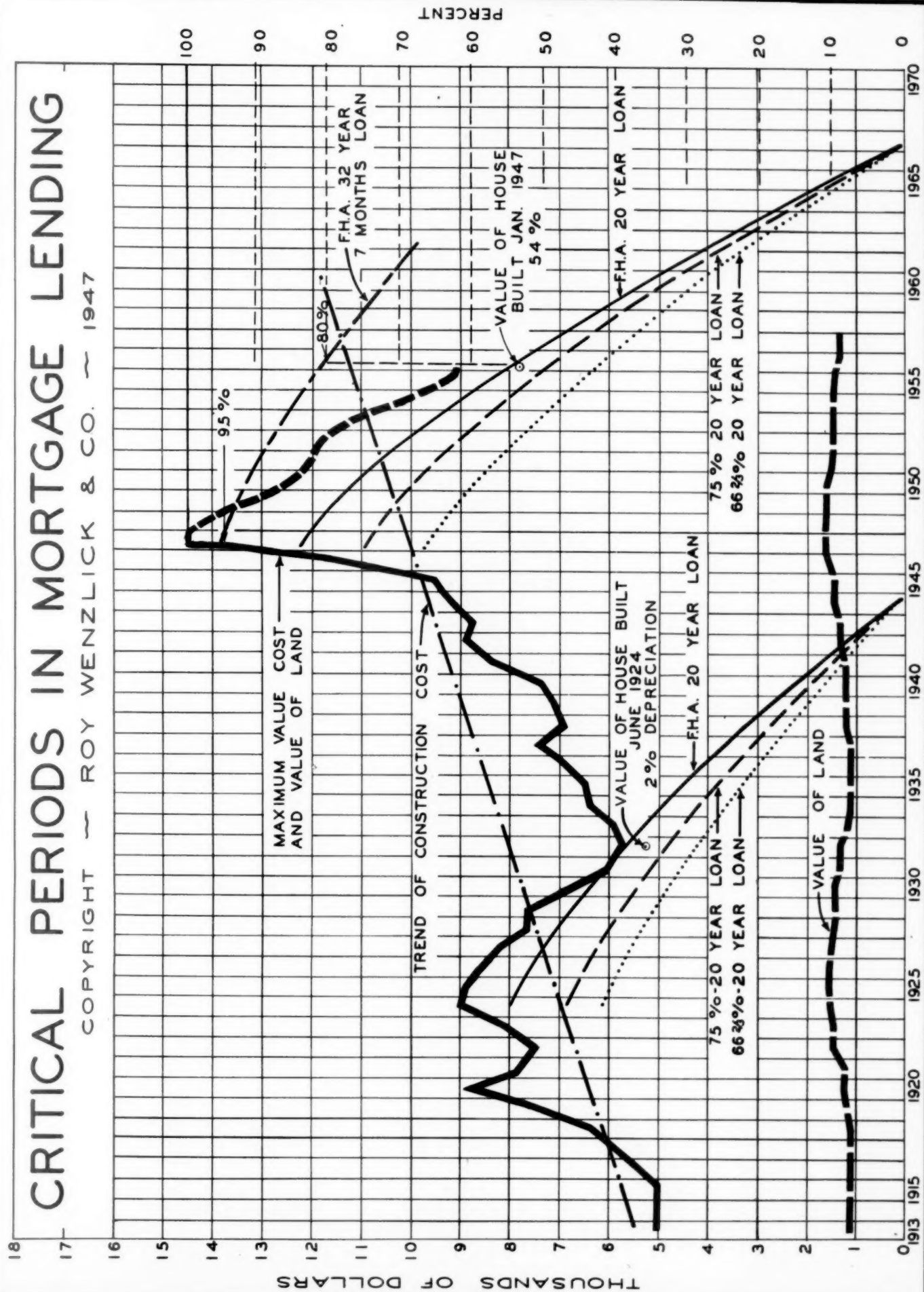
The upward and downward movements in construction cost during this 43-year period shown on the chart are very important to the mortgagee. It is evident from a study of this chart that in the 14-year period from 1931 to 1945 there was a continuous upward trend and a time exceptionally favorable for making loans; in fact, in almost every year of this period a 20-year amortized loan representing 100 per cent of the value of the house new could have been made with perfect safety to both the mortgagee and the mortgagor. Therefore, it is not surprising to find the 80 per cent to 90 per cent FHA 20-year amortized loans (established 1934) made during this period to be exceptionally safe with a very low loss experienced. Likewise, the period from 1913 to 1919 was one of rising costs, and quite favorable for loan purposes.

On the other hand, the critical or the comparatively unsafe periods for making loans would be those periods where construction costs undergo a continuous sharp decline for several years. Up to the present, or during the past 34 years, there has only been one critical period, from 1924 to 1931, when the value of the house dropped 36.3 per cent in the eight years. During these new era days of the twenties, the amortized loan was not commonly used; mortgagees preferred senior and junior financing without amortization and they felt that amortization was quite unnecessary. In New York City it was generally believed that the value of the land would increase faster than costs would decline or buildings depreciate. Many loans were made in amounts above 100 per cent of value. While this attitude contributed to real estate's greatest disaster throughout the country, it is interesting to note that if the FHA had been in effect in 1924, and if a loan of \$7,900 (87 per cent), amortized in 20 years, had been placed on the house in 1924 with a value of \$9,100, the balance due on the loan would be above the value of the house in 1932, using an annual depreciation of 2 per cent. (See chart.) 75 per cent and 66-2/3 per cent loans, each amortized in 20 years, are shown on the chart as extremely conservative and safe.

The second critical period is the period forecast from 1947 to 1955, when the value of the house is estimated to decline 37 per cent, or about the same percentage experienced in 1932. If an 84 per cent, 20-year amortized loan for \$12,200 were placed on the house in 1947, by 1955 the balance due on the loan would be above its value, allowing 2 per cent for annual depreciation of the house. Again as in 1924, both the 75 per cent and the 66-2/3 per cent loans, amortized for 20 years, would be quite safe.

CRITICAL PERIODS IN MORTGAGE LENDING

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While we are entering a critical period when times are unfavorable for mortgage financing, and when risks are great, it is our belief that safe loans can be made if the mortgagee forms the mortgage pattern to meet those hazards of which he is fully aware. It is quite surprising, therefore, that Congress would require the government to insure fantastic financing of rental housing projects for veterans.

Under Section 608 of Title VI of the National Housing Act, which is practically a revival of the Defense Housing Projects of 1941, the amount of loan is restricted (1) to 90 per cent of the cost of land and improvements; or (2) if lot is furnished, to 100 per cent of the cost of the improvements; or (3) to a cost not exceeding \$1,800 per room; and (4) that not more than 91 per cent of net income can be used to service the loan. This loan, which many informed persons say will be 95 to 100 per cent of the cost of land and improvements, will bear 4 per cent interest and will be amortized in 32 years and 7 months. This high percentage loan and long amortization period is being insured at a critical time when financing is quite risky.

The requirements of the apartment are reduced almost to substandard levels in order to get the cost per room down to its restricted amount. The minimum requirements for living room are 150 square feet; for kitchen, 60 square feet; for second bedroom, 70 square feet; etc. Other requirements are more in line with defense projects of a more temporary nature than with modern apartments with adequate space for comfortable living.

In order to illustrate the effect of such a percentage loan and rate of amortization, it is assumed that the present cost of house and lot equals 100 per cent of the cost of land and improvements of a rental housing project. (See chart.) The loan is assumed at 95 per cent of this cost and the balance due by years on a 32-year, 7-month amortization is shown by the dotted red line. It is assumed that the reproduction cost of the apartment property will decline as rapidly and at the same rate as the standard frame house, whose value by 1955 on the basis of 2 per cent per year depreciation would decrease to 54 per cent. It will be noted that the balance due on the loan would be about 80 per cent of the original cost. Using these percentages as approximately correct, an apartment project built under this Section of the Housing Act for \$200,000 as the cost of land and improvements, would decline to \$108,000 by 1956; the balance of loan outstanding would be about \$160,000.

All moneys invested by persons owning the small equity (\$10,000) and paid on the amortization of the mortgage (\$30,000) would be lost by 1955 and the government which insured the loan would lose in addition to this amount approximately \$52,000 if the property were then sold at its worth. Of course, such losses would be expected from such a ridiculously high percentage loan and such fantastically long amortization at a hazardous time for financing.

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